No. 9832

In the United States Circuit Court of Appeals for the Ninth Circuit

Commissioner of Internal Revenue, petitioner

v.

Bishop Trust Company, Limited, Executor of the Estate of John A. McCandless, Deceased, respondent

ON PETITION TO REVIEW A DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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OPINION BELOW

The opinion of the Board of Tax Appeals (R. 18–29) may be found in 42 B. T. A. 1309.

JURISDICTION

This case involves the income tax of an estate for the fiscal year ended January 31, 1936. The decision of the Board of Tax Appeals was entered January 28, 1941 (R. 29–30), and the petition for review was filed April 19, 1941 (R. 30–37), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the income of a decedent's estate accumulated during the period of administration and paid over upon final settlement of the estate to the testamentary trustee of the residue was deductible as income properly paid or credited to a legatee within the meaning of Section 162 (c) of the Revenue Act of 1934.

STATUTE INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 162. NET INCOME.
>
> The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—
>
> * * * * *
>
> (c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary. (U. S. C., Title 26, Sec. 162.)

STATEMENT

The relevant facts may be summarized, principally from the opinion of the Board (R. 18–29), as follows:

The decedent, a resident of Honolulu, died on January 30, 1930. He disposed of a large estate by will, naming respondent, Bishop Trust Company, Ltd., as executor and also as the testamentary trustee of his residuary estate. The respondent qualified as executor and since the final settlement of the estate has acted as testamentary trustee. The will provided that the executor pay to the decedent's widow $1,000 per month during administration of the estate and $250 per month to each of four grandchildren. (R. 20.)

The provision in the will establishing the trust of the residuary estate was as follows (R. 21):

> Eighth. I give, devise and bequeath all of the rest, residue and remainder of my estate, real, personal or mixed, wheresoever situated and of every kind or nature, and any property over which I shall posses any power of appointment, to Bishop Trust Company, Limited, an Hawaiian corporation, in trust for the uses and purposes and with the powers as hereinafter stated, * * *

The trustee was directed to "pay and deliver from the accumulations and net income of my said trust estate" $1,000 per month to the widow until the youngest grandchild reached twenty-one after which the widow was to receive one-tenth of the annual net income of the trust. Similarly, the trustee was to "pay and deliver from the accumulations and net income" $250 per month to each grandchild, who was to receive

one-tenth of the annual net income of the trust after reaching twenty-one years of age. The surplus income of the trust estate was to be accumulated and invested. The trust was to terminate when the youngest grandchild reached thirty years of age and one-fifth of the estate was to be paid to the widow, if living, and one-fifth to each grandchild *per stirpes*. (R. 21.) In January, 1936, the executor filed a petition with the probate court requesting approval of its first and final account of the administration and requesting that "an order be made to deliver over such property as remains to the persons thereto entitled." On January 21, 1936, the probate court entered an order that the Bishop Trust Company, Ltd., should convey "the assets remaining in its hands as Executor" to itself as trustee. Pursuant to this order the Bishop Trust Company, Ltd., transferred and delivered to itself "the residue of the decedent's estate" and it was discharged as executor subject to the performance of specific acts which have since been performed. (R. 22, 23.) The respondent did not inform the Commissioner of his discharge as executor in the manner provided in Section 312 of the Revenue Act of 1934. (R. 4.)

The respondent kept its accounts and made its income tax returns on the cash basis. The returns were filed with the Collector at Honolulu. (R. 23.)

Included in the residuary estate of the decedent which was transferred to the respondent as testamentary trustee was $20,504.58 cash which had been received by the respondent, as executor, as income during the taxable year. The record does not indicate

that any of this income was distributed during the taxable year to the beneficiaries of the trust. In the return filed on behalf of the estate this amount was claimed as a deduction. In the determination of the deficiency herein involved the Commissioner disallowed this deduction on the ground that it was not allowable under the provisions of Section 162 (c). The Bishop Trust Company, Ltd., as testamentary trustee, in the return filed on behalf of the trust for the same fiscal year, included in the gross income of the trust $19,639.72 of the amount and paid income tax thereon. (R. 24.)

There were other deductions and issues before the Board, but on this appeal the only question is the deductibility of the amount of $20,504.58 from the income of the estate during the period of administration.

STATEMENT OF POINTS TO BE URGED

It is submitted that the Board of Tax Appeals erred in deciding and holding that the $20,504.58 income received by the estate during the taxable year was deductible from the estate's gross income under Section 162 (c); and in deciding and holding that such amount was paid to the testamentary trustee as income and not as part of the corpus of the trust.

SUMMARY OF ARGUMENT

The amount of income is taxable to the decedent's estate unless some statutory provision to the contrary is clearly established. Under the terms of this will and the provisions of local law, this income became part of the gross estate passing to the residuary trustee and therefore was not taxable as income in the hands of the

trustee. Since it was not paid or credited to a legatee, heir, or beneficiary as income, it was not deductible from the gross income of the estate during the period of administration. The Board committed legal error in holding to the contrary.

ARGUMENT

Estate income passing to a residuary trustee as corpus is not income paid or credited to a legatee

Under Section 161 (a) (3) of the Revenue Act of 1934, the income received by estates of deceased persons during the period of administration is subject to the taxes imposed upon individuals. In the present case the respondent is seeking a deduction from the amount of taxable income and therefore it must be established that there is some clear statutory provision by which the Congress intended to grant the claimed deduction. *New Colonial Co.* v. *Helvering,* 292 U. S. 435; *Deputy* v. *DuPont,* 308 U. S. 488. The taxpayer contends, and the Board agreed, that the amount of income received by the estate during the period of administration was deductible as income properly paid or credited to a legatee within the meaning of Section 162 (c).

We submit that by the terms of the will the income accumulated during the period of administration of the estate became part of the corpus of the estate and that the testamentary trustee took it over as such in January, 1936. The will provided that certain payments be made during the period of administration. (R. 20.) After certain specific bequests (R. 58–59), the "rest, residue and remainder * * *, real, personal or

mixed, wheresoever situated and of every kind or nature * * *" was devised and bequeathed to the testamentary trustee. (R. 21.) The petition of the executor to the probate court requested an order to "deliver over such property as remains * * *." Pursuant to this request the probate court ordered the executor to transfer the *assets* remaining in its hands. (R. 22.) The petition before the Board stated that the amount herein involved was "included in the residuary estate of the taxpayer" (R. 8) and the Board stated that the $20,504.58 cash was "included in the residuary estate of the decedent" (R. 24). The trustee was to control, manage and hold the trust and collect the income. (R. 60.) It could reinvest the unapplied income. (R. 61.) The payments were to be made from the "accumulations and net income" of the trust. (R. 21.) It is clear from the provisions that there was a difference between the payments to be made to the widow and grandchildren during the administration period and those to be made under the trust. During the period of administration the payments were to be made without regard to the presence or absence of income. The beneficiaries were to receive certain amounts and there was no requirement that such amounts be paid from the income of the estate, nor did they have any claim to the income as such. Since the will made no disposition of the income from the estate it became part of the corpus of the estate. That is, it became an indivisible part of the whole sum which was to pass as such to the residuary trustee. It thereby became the trust corpus from which income was to be derived to make certain payments to the beneficiaries of the trust.

Our contention is supported by the fact that the payments from the trust were to be made from the accumulations and net income of the *trust*. In other words, the payments during administration were to be made from any source (R. 57), while those from the trust were to be made only out of income earned or accumulated during the existence of the trust (R. 63, 64). The beneficiaries of the trust had no claim to the amount herein involved as income even after it reached the trust. Their claim was to be paid from the net income of the trust. Having differentiated between the two payments, the decedent clearly intended that the income received during the period of administration become part of the gross estate passing under the residuary clause, and not income which any legatee was entitled to demand. It is the intention of the testator that governs. *Hawaiian Trust Co.* v. *Von Holt,* 216 U. S. 367. Moreover, it is a fact that the parties so considered the accumulated income and it has not been paid to the beneficiaries as income. It was turned over as a part of the residuary estate out of which income might be payable, but not as income to which the beneficiaries of the trust were entitled.

Although the income became corpus of the estate, the trustee nevertheless received it. This but emphasizes the fact that the right of the trustee to receive it did not at all depend upon whether or not the estate possessed income. Recipients like the trustee, who are entitled to payments from an estate in any event, acquire by bequest, devise or inheritance and are not charged with the receipt of income. *Burnet* v. *Whitehouse,* 283 U. S.

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Inserts opposite page 9 Government's Brief in #9832, Comm'r of IR vs Bishop Trust

* Additional authorities supporting text in last paragraph of page 8:

Anderson's Estate vs. Comm'r,
126 F. (2d) 46, (CCA 9)

Comm'r vs. Shelden (CCA 6)
decided February 16, 1943.

Wilcox vs Comm'r, 43 B.T.A. 931
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Durkheimer vs Comm'r,
41 B.T.A. 585.

** Additional authorities supporting text of first sentence in last paragraph on page 9:

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148; *Weigel* v. *Commissioner,* 96 F. (2d) 387 (C. C. A. 7th). Cf. *Irwin* v. *Gavit,* 268 U. S. 161. The *Whitehouse* case, *supra,* held that where the terms of the will directed that an annuity be paid without reference to the existence or absence of income, then the annuity was not taxable as income to the beneficiary; it was property received by bequest and therefore not taxable to the annuitant.

Congress has allowed deductions only for income currently distributed and this Court has held that a payment to a recipient who was entitled to the money only because it was accumulated income is not a distribution of current income. *Spreckels* v. *Commissioner,* 101 F. (2d) 721. In the *Spreckels* case this Court held that the accumulated income of an estate which was not to be currently distributed was taxable to the estate and not to the beneficiary, even though the latter received it in the same taxable year during which it was accumulated. Cf. *Lynchburg Trust & S. Bank* v. *Commissioner,* 68 F. (2d) 356 (C. C. A. 4th).

Since the amount of $20,504.58 in this case was not paid or credited to a legatee as income, nor received as income, it was not deductible under Section 162 (c). *Weigel* v. *Commissioner, supra.* See also G. C. M. 22034, 1940-1 Cum. Bull. 90. Such sums must be actually distributed as income, and not as assets, to the beneficiary before the beneficiary is taxable. *County Nat. Bank & Tr. Co.* v. *Helvering,* 122 F. (2d) 29 (App. D. C.). Moreover, the Board itself recently held that if the sole beneficiary of a testamentary trust did not *actually receive* the income, then the profits of a part-

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nership of which the trust was a member were taxable to the estate. *Buckner* v. *Commissioner,* 45 B. T. A. No. 90.

The cases involving the law of Hawaii in this regard support our contention. In *Hawaiian Trust Co.* v. *Von Holt, supra,* there was involved a will with substantially the same effect as in the instant case. It was held that the beneficiary of the trust was not entitled to the income from the death of the testator, but only after the executor had been discharged and the property turned over to the trustee. In deciding the case of *Wilcox* v. *Wilcox,* 26 Haw. 219, the Supreme Court of the Territory of Hawaii expressly stated that the case was different from the *Von Holt* case. In the *Wilcox* case there was a dispute between life tenants and remaindermen concerning the income during the period of administration. The court decided in favor of the life tenants, holding that the provisions of the particular will clearly indicated an intention on the part of the testator that the trust fund corpus consist only of property of which he died possessed.

It is apparent that the Board erred in not giving proper effect to the provisions of the will and local law involved. The Board also erred in its interpretion of *White* v. *Commissioner,* 41 B. T. A. 525, and the *Weigel* case, *supra.* The decisive factor in the *Weigel* case was not that the particular income was a gain from the sale of capital assets. That was significant only because it demonstrated that it was not to be currently distributed. The rationale of the decision was that the

profit or income of the estate became part of the corpus of the trust by virtue of the will provisions. The fact that the profits come from capital gains is immaterial. *Chambers* v. *Commissioner,* 33 B. T. A. 1125. It is also immaterial whether the estate income becomes part of the trust corpus by virtue of the will provisions or by the force of local law. *Weigel* v. *Commissioner, supra.* It is apparent that in the *White* case the income was carefully segregated from the rest of the funds. Moreover, part of it was actually paid to the beneficiary. The Commissioner did not acquiesce in that decision. 1940-1 Cum. Bull. 9.

The Board, having found that the cash here was an asset and part of the residuary estate (R. 21–24), erred in not determining that it was not income paid or credited to a legatee.

CONCLUSION

Since the decision of the Board of Tax Appeals that there was a reduced deficiency is not supported by the evidence and is based on legal error, it should be reversed and the deficiency as asserted by the Commissioner should be reinstated.

Respectfully submitted.

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November 1941.

U S GOVERNMENT PRINTING OFFICE: 1941